

APPEALS
COORDINATED ISSUE PROGRAM
APPEALS SETTLEMENT GUIDELINES

INDUSTRY: All Industries

ISSUE: Sections 302/318 Basis Shifting Transactions

COORDINATOR: Jerry Savard

TELEPHONE: (312) 886-1010

FACSIMILE: (312) 886-2709

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APPROVED:

for Thomas C. Lillie
DIRECTOR, TECHNICAL GUIDANCE

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Beverly Olesza Boh
DIRECTOR, TECHNICAL SERVICES

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Appeals Coordinated Issue

I.R.C. §§ 302/318 Basis Shifting Issue

Jerry Savard
Appeals ACI Coordinator

The Issues

1. Whether a loss on the sale of stock is deductible following a series of pre-arranged steps with the purpose of creating a high tax basis in such stock.
2. Whether the Internal Revenue Service should assert the appropriate I.R.C.¹ § 6662 accuracy-related penalties against taxpayers² who entered into the “basis shifting” transactions.

Executive Summary

In Notice 2001-45, 2001-33 I.R.B. 129, the Service identified a number of abusive I.R.C. § 302 Basis Shifting transactions. These transactions rely on the interplay between I.R.C. § 302 (Distributions in Redemption of Stock) and I.R.C. § 318 (Constructive Ownership of Stock). In a typical transaction, foreign corporation purportedly purchases foreign bank stock that is purportedly redeemed. The U.S. taxpayer argues that, in applying the attribution rules of I.R.C. § 318 of the Internal Revenue Code and § 1.302-2(c) of the Income Tax Regulations, it increases its basis in foreign bank stock by the basis that the foreign corporation had in the foreign bank stock redeemed. The U.S. taxpayer then claims a loss upon disposition of its foreign bank stock.

In the transaction, there is a redemption of stock owned by foreign corporation, which is not subject to U.S. tax and is indifferent to the Federal income tax consequences of the redemption. As a result of the application of the attribution rules of I.R.C. § 318, the redemption of stock is claimed to be a dividend under I.R.C. § 301 rather than a payment in exchange for stock under I.R.C. § 302(a). A variety of devices, often including options and a warrant, are employed to treat the redeemed shareholder as owning stock in the redeeming corporation owned or treated as owned by the taxpayer under the attribution rules of I.R.C. § 318. The taxpayer argues that the attribution of ownership of such shares prevents the redemption of stock from reducing the redeemed shareholder's ownership interest in the redeeming corporation, thereby causing the redemption to be treated as a dividend.

¹ As used herein, I.R.C. refers to the Internal Revenue Code of 1986.

² As used herein, the term “taxpayer” refers to an “investor” in the transactions. These “investors” may be individuals, partnerships, corporations or trusts.

As a result of the redemption, the taxpayer takes the position that under Treas. Reg. § 1.302-2(c) all or a portion of the basis of the redeemed stock is added to the basis of stock in the redeeming corporation that the taxpayer owns. The taxpayer then sells the latter stock and claims a loss. This capital loss is used to offset other capital gain income.

The Foreign Leveraged Investment Program (FLIP) and the Offshore Partnership Investment Strategy (OPIS) are two of the more prominent names given to these transactions.

In Notice 2001-45, the Internal Revenue Service and the Treasury Department alerted taxpayers and their representatives that the tax benefits purportedly generated by such transactions are not properly allowable for federal income tax purposes.

On December 11, 2001, Appeals designated the I.R.C. §§ 302/318 Basis Shifting Issue as an Appeals Coordinated Issue.

There are two basic arguments raised by the Service against the I.R.C. §§ 302/318 Basis Shifting Shelters:

- The foreign corporation never had an ownership interest in the shares of foreign bank stock that were purportedly redeemed. (Alternatively, the step transaction doctrine and substance-over-form principles apply to disregard foreign corporation's purported acquisition and disposition of the shares of foreign bank stock.)
- If foreign corporation is treated as having properly acquired the shares of foreign bank stock and such stock is treated as having been redeemed by foreign bank, under Zenz and step transaction principles, foreign bank's redemption of its stock from foreign corporation is an exchange to which I.R.C. § 302(a) applies rather than a dividend distribution governed by I.R.C. § 301.

Additionally, the Service argues the losses are disallowed under I.R.C. § 165, I.R.C. § 269, I.R.C. § 465, and the economic substance and business purpose arguments under the sham transaction doctrine.

The taxpayers argue that the basis shifting transaction met the requirements of the Internal Revenue Code and Regulations. Further, under the transaction, there was a purchase and sale of the foreign bank stock by the foreign corporation. In addition to disputing all other arguments raised by the Service, the taxpayers argue that the transaction does not lack economic substance or a non-tax business purpose.

The I.R.C. §§ 302/318 Basis Shifting Issue is made up of three components:

- The Basis Shifting Loss
- The Transaction Costs

Most recently, taxpayers were provided an option to settle I.R.C. §§ 302/318 cases. This guidance was provided in Announcement 2002-97.

Issue 1 Statement of the Issue

In Notice 2001-45, the Service identified a number of abusive I.R.C. § 302 Basis Shifting transactions. These transactions rely on the interplay between I.R.C. § 302 (Distributions in Redemption of Stock) and I.R.C. § 318 (Constructive Ownership of Stock). The players include a U.S. taxpayer with a large potential capital gain tax liability, a foreign corporation located in a foreign tax haven, a foreign bank and a promoter.

Issue 1

Brief Statement of the Facts

While there are some variations in the various steps, the typical pattern is as follows:

The taxpayer is a U.S. taxpayer with substantial capital gains. The taxpayer desires to shelter these gains from tax. After consultation with a promoter and/or advisor, the taxpayer purchases a small number of shares of the stock of the foreign bank on the open market. The foreign bank is a widely held, publicly traded foreign bank that is not subject to U.S. tax. In addition, the taxpayer purchases from the foreign corporation, also not subject to U.S. tax, a warrant to acquire at least 50 percent of the outstanding stock of the foreign corporation. The remaining issued and outstanding stock of the foreign corporation is typically owned by a foreign person or persons also not subject to U.S. tax. The warrant allows the taxpayer the option to “put” the warrant back to the foreign corporation. Under this “put” option, the taxpayer may surrender the warrant for an amount based on a percentage of the foreign corporation’s net asset value.

The foreign corporation purportedly borrows money from the foreign bank in approximately the amount of the taxpayer’s capital gain. With the proceeds of that purported loan, the foreign corporation purportedly purchases bearer shares of the foreign bank, and the foreign bank bearer shares allegedly secure the loan. In actuality, however, the foreign corporation enters into a contractual obligation to buy a specified number of foreign bank bearer shares for a fixed price on a future settlement date. The bearer shares remain in the foreign bank’s possession. Settlement on the foreign bank stock acquisition contract is set for a date at least 30 days in the future. Payment for and delivery of the foreign bank shares will occur, if at all, on the settlement date. At the same time that the foreign corporation enters into the contract to acquire foreign bank bearer shares on a future settlement date, the foreign corporation purchases put options from the foreign bank, obtaining the right to sell its foreign bank bearer shares to the foreign bank. The put options are out of the money. In addition, the foreign corporation sells foreign bank call options with a strike price reset feature, giving the foreign bank the right to purchase its bearer shares at a price below the stock purchase price and

limiting the foreign corporation's opportunity for gain. The call options include an integrated forward feature that, in the event of a change in the value of the foreign bank stock, may result in income or gain to the foreign corporation. The call options are in the money.

Purportedly, on or about the settlement date, the foreign bank redeems the foreign bank stock owned by the foreign corporation. The foreign bank effects this redemption through the exercise of its call options. The foreign corporation purportedly uses the redemption proceeds to repay the purported loan from the foreign bank. On or about the settlement date, the taxpayer purchases call options to acquire the same number of foreign bank shares as the number of foreign bank shares that the foreign corporation contracted to purchase.

In some variants of the transaction, the taxpayer then transfers its foreign bank stock (and possibly its foreign bank call options) to a partnership or a grantor trust.

The taxpayer (or the partnership or the grantor trust) then sells all or a significant portion of the foreign bank stock. At some point before or after the stock sale, the taxpayer (or the partnership or the grantor trust) also surrenders the foreign corporation warrant. The taxpayer (or the partnership or the grantor trust) either sells the foreign bank call options or allows them to lapse, often with a relatively insignificant amount of gain or loss.

The series of transactions is generally accomplished within several months.³

Typically, the promoter not only markets the plan, but also makes the necessary arrangements to accomplish the various steps and monitors the entire transaction to ensure that the steps within the transaction are done timely and in accordance with the plan. Known variations include the use of other derivative products in lieu of stock or options, as well as the use of the transaction to reduce gain (rather than generate loss).

In step form, the transaction would be described as follows:

| <u>Step</u> | <u>Description</u> |
|-------------|---|
| 1 | The taxpayer purchases shares of foreign bank stock either directly from the foreign bank or on the open market. |
| 2 | The taxpayer contributes cash to a foreign corporation in exchange for a warrant that entitles the taxpayer to acquire a specified number of newly issued shares of the foreign corporation. If the warrant is exercised, the |

³ The series of transactions generally occur within a single taxable year. However, in one variation, the taxpayer (or the partnership or the grantor trust) sells the bulk of its foreign bank shares (e.g. 90%) in one year and the rest two years later.

taxpayer would own more than 50% in value of the stock of the foreign corporation.

- 3 The foreign corporation enters into a contractual obligation to buy a specified number of foreign bank bearer shares for a fixed price at a future settlement date. Contemporaneously, the parties enter into call and put options. The call options (written by the foreign corporation and held by the foreign bank) are European-style⁴ options that are exercisable on a single date that is on or about the settlement date. The strike price is set at 95 percent of the stock purchase price. The strike price, however, will be adjusted downward to 90 percent (strike reset price), if the actual stock price falls below the barrier price, which is calculated to be 95 percent of the stock purchase price. The call options also have an integrated forward feature. Under this feature, foreign bank is required to pay a fixed amount to foreign corporation if the share price of foreign bank stock exceeds certain levels during specific time periods. If at any time the share price of foreign bank stock falls below the strike reset price, foreign bank would pay to foreign corporation an amount equal to a fixed amount multiplied by the number of days prior to the share price falling below the strike reset price. The put options (written by the foreign bank and held by the foreign corporation) are also European-style options exercisable on the same date as the call options. The strike price is 90 percent of the stock purchase price.
- 4 Foreign bank exercises its call options and “reacquires” the shares purportedly sold to foreign corporation in step three. On or about the same day, the taxpayer also purchases call options to acquire shares of foreign bank stock equal to the number of shares purportedly purchased by the foreign corporation. Treating the redemption as a distribution to which I.R.C. § 301 applies, the taxpayer adds the foreign corporation's purported basis in its “redeemed” foreign bank stock to the taxpayer’s basis in its foreign bank stock and options.

⁴ As opposed to American-style options that can be exercised at any time between the purchase date and the expiration date, European-Style options are options that can only be exercised for a short specified period of time just prior to their expiration, usually a single day.

- 5 The taxpayer sells its foreign bank shares and options, the basis of which the taxpayer increased by foreign corporation's purported basis in foreign bank stock, and claims significant capital losses upon the disposition of the stock and options.

**Issue 1
Sub-Issues**

1. Whether the foreign corporation ever had an ownership interest in the shares of foreign bank stock that were purportedly redeemed. (Alternatively, whether the step transaction doctrine and substance-over-form principles apply to disregard foreign corporation's purported acquisition and disposition of the shares of foreign bank stock.)
2. If foreign corporation is treated as having properly acquired the shares of foreign bank stock and such stock is treated as having been redeemed by foreign bank, whether, under Zenz and step transaction principles, foreign bank's redemption of its stock held by foreign corporation is an exchange to which I.R.C. § 302(a) applies or a dividend distribution governed by I.R.C. § 301.
3. Whether the taxpayer's purported loss was a bona fide loss allowable as a deduction under I.R.C. § 165.
4. Whether the taxpayer acquired control of foreign corporation with a principal purpose of avoiding or evading Federal income tax with the result that the purported loss is disallowed under I.R.C. § 269.
5. Whether the at-risk provisions of I.R.C. § 465 limit the taxpayer's capital losses claimed.
6. Whether the losses may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

Administrative Background

On July 26, 2001, the Service issued Notice 2001-45. In the Notice, the Service and the Treasury Department announced that they had become aware of a type of transaction that is being used by taxpayers for the purpose of generating losses or reducing income or gains. The Notice alerted taxpayers and their representatives that the tax benefits purportedly generated by such transactions are not properly allowable for Federal income tax purposes. This Notice also alerts taxpayers, their representatives and promoters of such transactions of certain responsibilities that may arise from participating in such transactions.

Following a discussion of the facts and an analysis of the law and arguments, the Notice concludes that the Service intends to disallow losses claimed (or to increase taxable income or gains) in the transaction described in this Notice to the extent a taxpayer derives a tax benefit that is attributable to stock basis purportedly shifted from the redeemed shares. Depending on the facts of the particular case, reasons for disallowance may include, but are not limited to, the following: (1) the redemption does not result in a dividend (and consequently there is no basis to shift) because, viewing the transaction as a whole, the redemption results in a reduction of interest in the redeeming corporation to which I.R.C. § 302(b) applies; and (2) there is no basis shift because the steps taken to achieve those results serve no purpose other than tax avoidance.

In addition, the Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under I.R.C. § 6662, the return preparer penalty under I.R.C. § 6694, the promoter penalty under I.R.C. § 6700, and the aiding and abetting penalty under I.R.C. § 6701.

Finally, the Notice provides that transactions that are the same as, or substantially similar to, those described in this Notice are identified as "listed transactions" for purposes of § 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations.

I.R.C. § 302(a) provides that if a corporation redeems its stock and I.R.C. § 302(b)(1), On December 11, 2001, Appeals designated the I.R.C. §§ 302/318 Basis Shifting Issue as an Appeals Coordinated Issue.

Discussion and Analysis

(2), (3), or (4) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the redeemed stock. Under I.R.C. § 302(b)(1), a redemption distribution will be subject to I.R.C. § 302(a) if, based on the facts and circumstances, the redemption distribution is not essentially equivalent to a dividend. See Treas. Reg. § 1.302-2(b). I.R.C. § 302(b)(2) provides that a distribution in redemption of stock will be subject to I.R.C. § 302(a) if the distribution is substantially disproportionate with respect to the redeeming shareholder. Under I.R.C. § 302(b)(3), I.R.C. § 302(a) will apply to a distribution in redemption of stock if the redemption is in complete redemption of all of the stock of the corporation owned by the redeeming shareholder. I.R.C. § 302(b)(4) does not apply to basis shifting transactions.

For purposes of determining whether a distribution in redemption of stock is treated as a sale or exchange of stock, all steps that are part of a single pre-arranged plan are taken into account. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). I.R.C. § 302(d) provides that if I.R.C. § 302(a) does not apply, the distribution will be treated as a distribution subject to I.R.C. § 301. I.R.C. § 302(c)(1) provides that, in determining whether the provisions of I.R.C. § 302(b) are satisfied, the attribution rules of I.R.C. § 318 shall apply. I.R.C. § 301(c)(1) provides that the portion of the distribution that is a

dividend shall be included in the redeemed shareholder's gross income.

Treas. Reg. § 1.302-2(c) provides that when an amount received in a redemption of stock is treated as a distribution of a dividend, "proper adjustment" of the basis of the remaining stock will be made with respect to the stock redeemed. Example 2 of Treas. Reg. § 1.302-2(c) illustrates a proper adjustment where the entire amount received in redemption of the stock held by one spouse is treated as a dividend because the redeemed spouse is treated as owning stock held by the other spouse. In that example, the basis of the stock of the non-redeemed spouse is increased by the basis of the stock of the redeemed spouse. It is noted that the example in the regulations is apparently premised on the concept that an adjustment is proper where the redeemed spouse is required to include the full redemption proceeds as a dividend in gross income that is subject to U.S. tax and such spouse retains no stock to which the basis of the redeemed stock could attach.

An Analysis of the Sub-Issues

Sub-Issue 1

Whether foreign corporation had an ownership interest in foreign bank. The application of the step transaction doctrine and substance-over-form principles.

The Service's Position

Foreign corporation did not purchase and own the shares of foreign bank stock that were purportedly redeemed. Alternatively, the step transaction doctrine and substance-over-form principles apply to disregard foreign corporation's purported acquisition and disposition of the shares of foreign bank stock.

The Service argues that, on the date of the purported purchase, foreign corporation and foreign bank entered into a forward contract for foreign corporation to purchase foreign bank bearer shares from foreign bank on a future settlement date. However, foreign corporation never purchased or owned the foreign bank shares.

The taxpayer alleges foreign corporation purchased foreign bank bearer shares. However, no facts show foreign corporation acquired the bearer shares on the date of the purported purchase through actual possession, a custodial agreement, or other arrangement showing transfer of beneficial ownership. It is clear that a completed purchase did not occur on the date of the purported purchase. Payment was not to occur on the date of the purported purchase and the documents clearly envision a closing on the settlement date, at which time foreign bank was to deliver foreign bank shares (if foreign bank was to deliver foreign bank shares at all). Moreover, foreign corporation was not entitled to any dividends on the foreign bank shares paid between the purported purchase date and the settlement date.

According to the Service, the taxpayer has produced no loan documentation or other proof sufficient to create a question of fact regarding the funds available to foreign

corporation to use as consideration to pay the purported purchase price. Some taxpayers have produced a spreadsheet indicating an amount foreign corporation purportedly "borrowed" from foreign bank on the purported purchase date. However, the taxpayer has produced no loan agreement, no loan documentation, and no loan application, etc. Furthermore, the documents indicate that, under the terms of the agreement, foreign bank was not to transfer the foreign bank bearer shares (if it was to transfer these shares at all) until the settlement date and foreign corporation was not to "pay" for the shares (if it was to pay for the shares at all) until the settlement date.

The facts indicate foreign corporation did not purchase the foreign bank shares on the purported purchase date. Instead, on the purported purchase date, foreign corporation and foreign bank entered into a forward contract that obligated foreign corporation to pay for, and foreign bank to deliver, foreign bank bearer shares on the settlement date. No consideration for the shares was to pass from foreign corporation to foreign bank until the settlement date at which time foreign bank was to deliver foreign bank shares.

The purchase and sale of foreign bank shares was to occur (if at all) by delivery of the shares on the settlement date. If foreign bank did not deliver the foreign bank shares on the settlement date, foreign corporation did not own the foreign bank shares on this date, and, in fact, never owned the foreign bank shares. Cf. Modesto Dry Yard, Inc. v. Commissioner, 14 T.C. 374 (1950), acq. 1950-2 C.B. 3 (partial prepayments for future delivery of raisins did not cause tax ownership of raisins to transfer earlier than delivery).

Obligation to Deliver under the Forward Contract Offset Against Obligation to Deliver under the Call Options -- The Two Obligations Cancelled

A forward contract is a transaction in which two parties agree to the purchase and sale of a security, financial instrument, commodity or other property at a future date, known as the settlement date. See Freytag v. Commissioner, 89 T.C. 849, 851-852 (1987), aff'd 904 F.2d 1011 (5th Cir 1990), aff'd 501 U.S. 868 (1991). There are no federal income tax consequences when a forward contract is executed. A forward contract is generally treated as an "open transaction." As a result, the tax consequences are deferred until the property subject to the contract is delivered, or the contract is otherwise "closed" or settled. See e.g., Rev. Rul. 69-93, 1969-1 C.B. 139, Rev. Rul. 81-167, 1981-2 C.B. 45 (ownership did not pass to the future purchaser of property on the date on which the executory contract was executed, but rather, on the settlement date on which the purchaser paid for the property and obtained title and possession); Freytag, 89 T.C. at 856-857; STEVEN D. CONLON & VINCENT M. AQUILINO, PRINCIPLES OF FINANCIAL DERIVATIVES, U.S. AND INTERNATIONAL TAXATION, ¶ B1.02 [1] (1999). The forward purchaser is not treated as purchasing and owning the property under the forward contract until delivery (if any) of that property under the forward contract.

The obligations under a forward contract may be cancelled before delivery of the underlying property, and the contract may "close" without delivery of the underlying property. See e.g. Freytag, 89 T.C. at 856-857; STEVEN D. CONLON & VINCENT M.

AQUILINO at ¶ B1.02[2][a] (1999). The call (and put) options that foreign corporation and foreign bank created at the time of entering into the forward contract provided that foreign corporation's obligation under the call (or put) options could be discharged against and in satisfaction of foreign bank's obligation to deliver bearer shares under the forward contract arrangement. Foreign bank purportedly exercised the call options on their exercise date. Through the exercise of the calls, foreign bank's obligation to deliver bearer shares under the forward contract was cancelled. As a result, foreign bank's obligation to deliver foreign bank shares to foreign corporation under the forward contract was cancelled before foreign bank delivered shares to foreign corporation, and the contract "closed" without delivery of any shares. In substance, the effect of the exercise of the calls was that the obligations of foreign corporation and foreign bank were settled by paying a net cash amount.

In summary, foreign bank's obligation to deliver foreign bank shares to foreign corporation was cancelled before foreign bank ever delivered any foreign bank bearer shares to foreign corporation. Consequently, foreign bank never delivered any shares to foreign corporation and foreign corporation never purchased or owned any foreign bank shares.

According to the Internal Revenue Service, on the exercise date, foreign corporation had not purchased, and moreover, did not have the financial ability to obtain, foreign bank shares to discharge its obligation under the call options. On or about the settlement date, foreign corporation's net worth was minimal or non-existent. Consequently, it is evident that foreign corporation's obligation to deliver foreign bank shares under the calls was to be discharged against and in satisfaction of foreign bank's obligation to deliver the bearer shares under the forward contract arrangement, and this is exactly what transpired.

Any Purported Interest Foreign Corporation Had in the Foreign Bank Shares Was, At Best, Transitory and Should Not Be Respected As an Ownership Interest under the Step Transaction Doctrine and Substance-Over-Form Principles

Alternatively, the Service argues that if foreign corporation "purchased" foreign bank shares on the settlement date, these shares were immediately "redeemed" by foreign bank on the same date when foreign bank exercised (or settled) its call options. Apparently, any purported loan extended to foreign corporation by foreign bank was made and satisfied at the same time the call options that affected the redemption were exercised (or settled). In short, foreign corporation's interest, if any, in foreign bank shares was, at best, a transitory interest that should not be respected as an ownership interest for federal tax purposes.

Courts opine that a transaction should be taxed according to its substance rather than its form. Gregory v. Helvering, 293 U.S. 465 (1935). Courts have applied the step transaction doctrine as a rule of substance over form to treat a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Penrod v. Commissioner, 88

T.C. 1415, 1428 (1987). Courts have developed three tests in applying the step transaction doctrine.

The most limited is the "binding commitment" test. If, when the first transaction was entered into, there was a binding commitment to undertake the later transaction, the transactions are aggregated. Commissioner v. Gordon, 391 U.S. 83 (1968); Penrod, 88 T.C. at 1429.

Under the "end result" test, if a series of formally separate steps are prearranged parts of a single transaction intended from the outset to achieve the final result, the transactions are combined. Penrod, 88 T.C. at 1429. This test relies on the parties' intent at the time of the transactions, which can be derived from the actions surrounding the transactions. For example, a short time interval suggests the intervening transactions were transitory and tax-motivated.

A third test is the "interdependence" test, which considers whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without completing the series of transactions. Greene v. United States, 13 F.3d 577, 584 (2d Cir. 1994); Penrod, 88 T.C. at 1430. One way to show interdependence is to show that certain steps would not have been taken in the absence of the other steps.

The Service argues that if foreign corporation is viewed as "purchasing" foreign bank shares, this "purchase" should not be respected for federal tax purposes because it was effectively negated on the same day when foreign bank exercised (or settled) its call options (i.e., to "reacquire" the foreign bank shares purportedly "purchased" by foreign corporation). In short, foreign corporation's "purchase" of foreign bank shares was, at best, transitory and should be disregarded under step transaction and substance-over-form principles. Foreign corporation never purchased or owned (beneficially or otherwise) any foreign bank shares and never had any tax basis in foreign bank shares that could be shifted to other parties. Instead, on the settlement date, foreign corporation and foreign bank merely transferred to each other the net difference in their respective payment obligations.

Even if Foreign Corporation could be viewed as having "purchased" Foreign Bank bearer shares, Foreign Corporation should not be viewed as having owned the shares.

Even if foreign corporation could be viewed as having "purchased" foreign bank bearer shares either on the date the forward contract was entered into or the settlement date, foreign corporation still should not be treated as the owner of foreign bank shares under the traditional benefits and burdens of ownership test. That is, foreign corporation should not be treated as the owner of foreign bank shares, for Federal tax purposes, unless foreign corporation had the benefits and burdens of ownership of these shares. See Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

In determining whether a party has the benefits and burdens of ownership, courts have considered various factors. These factors include: (1) whether the sale price was fixed;

(2) whether a significant amount of the agreed price has been paid; (3) the descriptive terms used in the agreement; (4) whether an effective date has been agreed upon fixing a specific time for recognition of the rights and obligations of the party; (5) whether the purchaser bears the risk of loss and opportunity for gain; (6) whether legal title has passed; (7) the intent of the parties; and (8) the probability that the transaction would be consummated. See Grodt & McKay Realty, Inc., 77 T.C. at 1237-38; Clodfelter v. Commissioner, 48 T.C. 694, 700-01 (1967), aff'd, 426 F.2d 1391 (9th Cir. 1970); Maher v. Commissioner, 55 T.C. 441, 451-52 (1970), aff'd in part and remanded in part, 469 F.2d 225 (8th Cir. 1972), nonacq.1977-2 C.B. 2. Not all listed factors must be present for the transaction to be treated as a sale. Maher, 55 T.C. at 452.

A benefits and burdens analysis here leads to the conclusion that foreign corporation, in substance, did not own the foreign bank shares. First, it does not appear that foreign corporation (the purported purchaser) bore the risk of loss and opportunity for gain. The simultaneous put and call options effectively collared foreign corporation's potential risk of loss and opportunity for gain. When the options were created, the spread of the collars was only a small percentage of the share price. Furthermore, since the strike price of the call was below the then current price of foreign bank shares, foreign corporation forfeited opportunity for gain outside the spread. The put also limited foreign corporation's risk of loss.

It is clear that foreign corporation and foreign bank did not intend for sales of foreign bank shares to occur. The strike prices of the put and call options between foreign bank and foreign corporation were set so that the parties knew at the inception of the options that one would be exercised,⁵ resulting in the virtual certainty that foreign bank would "reacquire" its own shares.

In addition to the general benefits and burdens of ownership case law, there is specific authority that a collar on shares may act to transfer ownership of those shares. See Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978). In Penn-Dixie, the taxpayer sought to treat a collar transaction as a sale, in part, because the possibility that a put and call would not be exercised was so remote that it should be ignored. The taxpayer had purchased stock and then sold a put and bought a call on the stock. The

⁵ If the price of foreign bank stock exceeded the applicable strike price, foreign bank would act in its economic interest to acquire the shares for the lower strike price. If the price of foreign bank stock was less than the lower strike price, foreign corporation would exercise the put. If the price of foreign bank stock equaled the lower strike price, either foreign corporation would exercise the put or foreign bank would exercise the call. Only in the unlikely event that foreign bank stock approximately equaled the strike price, might foreign bank arguably not have an economic interest in exercising the call. However, even under those circumstances, foreign corporation would exercise the put. Foreign corporation arguably would have been unable to borrow the funds necessary to purchase the shares. Furthermore, either the call or the put had to be exercised to effect the purported redemption necessary to assert the alleged basis shift.

court disagreed with the taxpayer but assumed, without deciding, that there may have been a different result had the put and call both been exercisable and expired on the same date. The court also indicated that if the term of the put and call had been shorter, the result may have been different. *Id.* at 844. In a subsequent case, the Tax Court concluded that because there was only a remote possibility that neither a put nor a call would be exercised, the put and call had resulted in a shift of the burdens and benefits of ownership. See *Kwiat v. Commissioner*, 64 T.C.M. (CCH) 327 (1992).

Foreign corporation had an opportunity for gain from the embedded or integrated forward feature terms of the call options. According to these provisions, the embedded forward feature (or recap) terms gave foreign corporation limited opportunity to benefit from the appreciation of foreign bank stock during the fixed term of the calls and puts. Under the terms of the call options, foreign bank would pay foreign corporation additional amounts for any trading day during that term when the price of foreign bank stock appreciated to certain preset prices. There were typically four increasingly higher pricing levels for four consecutive periods. In the event the price of foreign bank stock fell to the barrier strike price during the fixed term, additional amounts would only be paid for days prior to that event. However, in order for foreign corporation, and ultimately the taxpayer, to benefit from these terms, foreign bank stock would have to appreciate significantly over the term without ever dipping to the barrier strike price.

Further evidencing foreign corporation's lack of intent to purchase the shares is the fact that foreign corporation did not have the financial ability to purchase foreign bank shares. At or about the settlement date, foreign corporation had a minimal or nonexistent net worth, even before taking into account certain fees to be paid to foreign bank or the promoter.

Moreover, certain documents indicate foreign bank was just an accommodation party not at risk in the transaction. These documents indicate the promoter (or a party related to the promoter) agreed to reimburse foreign bank for -- or provide foreign bank with -- whatever amounts foreign bank would be required to make to foreign corporation in the transaction.

The Taxpayers' Position

The taxpayers take the position that the underlying facts and existing documentation make it clear that this was a purchase and sale of stock and not a forward contract. The existing documents, the amount paid for the stock (including the deposit), the existence under law of voting and other shareholder rights, the intent of the parties, and other factors make it clear that the benefits and burdens of ownership of the foreign bank shares clearly passed to the foreign corporation. The taxpayers argue the foreign bank retained possession of the stock as collateral, and this is neither unusual nor indicative that the stock was not owned by the foreign corporation.

The taxpayers argue that the question of whether the foreign corporation was the owner of the foreign bank shares depends on whether there was a sale of the shares for federal income tax purposes. According to the taxpayers, this is a mixed question of law

and fact, in which the primary issue is whether the foreign corporation obtained the benefits and burdens of ownership of the shares. See *Highlands Farms, Inc. v. Commissioner*, 106 T.C. 237, 253 (1996); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). The case law and the Service's published rulings indicate this requires analysis of multiple factors, but establishing all factors is not necessary. See, e.g., *Maher v. Commissioner*, 55 T.C. 441, 45 1-52 (1970). *aff'd in part and remanded in part*, 469 F.2d 225 (8th Cir. 1972), *nonacq.*, 1977-2 C.B. 2. In these cases, the evidence will show that the foreign corporation acquired substantially all the benefits and burdens of ownership and thus was the owner of the foreign bank shares.

The taxpayers argue the parties subjectively intended for a sale to take place, and the objective facts corroborate such intent. According to the taxpayers, the factors most often considered by courts, and their application to this case, are as set forth below:

Fixed Sales Price. The sales price for the shares was fixed; indeed, the shares were traded on the Zurich stock exchange. The foreign corporation agreed to pay the full price for the shares; the fact that the foreign bank financed the share purchase does not negate sale treatment, as discussed below.

Labels Given by the Parties and Date for Recognition of Rights. Insofar as the taxpayers are aware, the parties documented the transaction as a sale, effective as of a specified date, and after such date the foreign corporation bore the risk of loss and possessed the opportunity for income or gain from the shares. (See discussion below.)

Title. The passage of legal title for the bearer shares was accomplished by delivery of certificates to the buyer or its agent but, as noted below, the foreign bank retained the title as security for the loan to the foreign corporation. Retention of title as collateral is common in financial transactions and does not negate sales treatment. See, e.g., *Clodfelter v. Commissioner*, 48 T.C. 694 (1967), *aff'd*, 426 F.2d 1391 (9th Cir. 1970); *Commissioner v. Baertschi*, 412 F.2d 494 (6th Cir. 1969).

Risk of Loss and Opportunity for Gain. The foreign corporation partially hedged its investment in the shares by selling an in-the-money call option to, and by purchasing a put option from, the foreign bank. But the foreign corporation still retained the risk of losing as much as ten percent of the value of the foreign bank shares in Swiss francs, plus any currency depreciation if the functional currency of the foreign corporation was other than the Swiss franc. The foreign corporation had the opportunity to earn the "digital premium," net of the interest cost, plus or minus any currency gain or loss. The foreign corporation earned the call option premium received from foreign bank and paid out the (much smaller) put option premium. The foreign corporation had the right to receive any dividends on the foreign bank shares payable during the time it held the foreign bank shares and had the right to vote the shares. Both *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001) and *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), held that true sales occurred – and the purchaser of the securities was the owner for tax purposes – notwithstanding a much shorter holding period and hedging arrangements.

With regard to the substance-over-form and step transaction arguments, the taxpayers argue that the foreign corporation owned and sold the foreign bank stock and had a profit or loss on these transactions. There was substance to its ownership and its transactions in the stock. The taxpayers further argue that the step transaction argument cannot be applied to ignore the steps in a real transaction between real entities that have real consequences.

Appeals Settlement Consideration and Guideline

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Sub-Issue 2

Is the purported redemption of foreign bank stock an exchange under I.R.C. § 302(a) or a distribution to which I.R.C. § 301 applies?

The Service's Position

Even if foreign corporation is treated as having acquired the shares of foreign bank stock and foreign bank's reacquisition of those shares is treated as a redemption, the redemption should be treated as a payment in exchange for the stock under I.R.C. § 302(a) and not as a dividend distribution under I.R.C. § 301.

A redemption of stock is an acquisition by a corporation of its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. I.R.C. § 317(b). If the redemption meets any one of the four conditions described in I.R.C. § 302(b), the redemption will be treated as a distribution in part or full payment in exchange for the stock. I.R.C. § 302(a). If the redemption fails to satisfy any of these tests, I.R.C. § 302(d) provides that the redemption will be treated as a distribution of property governed by I.R.C. § 301.

I.R.C. § 302(b) provides sale or exchange treatment for redemptions that: (1) are not essentially equivalent to a dividend; (2) are substantially disproportionate; or (3) completely terminate a shareholder's interest in the corporation. I.R.C. §§ 302(b)(1)-(3).⁶

I.R.C. § 302(c) provides that the stock attribution rules of I.R.C. § 318 apply in determining whether a redemption qualifies for sale or exchange treatment. I.R.C. § 318(a)(2) provides constructive ownership rules from partnerships, estates, trusts, and corporations. Pursuant to I.R.C. § 318(a)(2)(C), if any person owns, directly or indirectly, 50 percent or more in value of the stock in a corporation, such person is

⁶ I.R.C. § 302(b)(4) does not apply to the transactions.

deemed to own the stock that such corporation owns, directly or indirectly, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. I.R.C. § 318(a)(3) provides constructive ownership rules to partnerships, estates, trusts, and corporations. Pursuant to I.R.C. § 318(a)(3)(C), a corporation is deemed to own all of the stock owned by a shareholder of the corporation who owns 50 percent or more in value of the stock in the corporation. I.R.C. § 318(a)(4) provides that a person who has an option to acquire stock shall be considered as owning such stock.

The taxpayer is treated as actually owning the foreign corporation shares that the taxpayer has the right to acquire under the foreign corporation warrant.⁷ The taxpayer is also treated as actually owning the number of foreign bank shares it has the right to acquire under the call options it purchased. Foreign corporation is deemed to own all of the foreign bank stock owned by the taxpayer since the taxpayer would have more than a 50 percent ownership interest in the foreign corporation if the foreign corporation warrant were exercised. The taxpayer argues that, after the redemption, foreign corporation is deemed to own at least as many foreign bank shares as it owned prior to the redemption. The taxpayer argues that, after application of the I.R.C. § 318 attribution rules, the redemption is neither a complete termination of the foreign corporation's interest in the foreign bank under I.R.C. § 302(b)(3) nor a substantially disproportionate redemption of the foreign corporation's interest in the foreign bank under I.R.C. § 302(b)(2).

The Service argues that, in the case of a complete termination of a shareholder's interest, the termination need not result solely from the redemption, but rather can result from a combination of the redemption and other stock dispositions. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (integrating a sale and redemption of stock to prevent dividend treatment); see also Rev. Rul. 77-226, 1977-2 C.B. 90 (holding that an integrated plan comprised of the partial redemption of stock, followed by the sale of the remainder of the stock to an unrelated third party, was a complete termination under I.R.C. § 302(b)(3)). The Zenz rationale is also applicable in determining whether a redemption is essentially equivalent to a dividend under I.R.C. § 302(b)(1). McDonald v. Commissioner, 52 T.C. 82, 87 (1969). Finally, the Service has approved the Zenz approach to I.R.C. § 302(b)(2) analyses. See Rev. Rul. 75-447, 1975-2 C.B. 113. The Zenz approach should also apply to a related termination of the stock ownership of a person whose stock ownership is attributed to the redeemed shareholder.

The Zenz doctrine applies to integrated plans. See Monson v. Commissioner, 79 T.C. 827 (1982); Rev. Rul. 75-447. Applying the Zenz analysis in this case, the taxpayer, as part of the integrated plan, sold all or most of its foreign bank stock and options shortly after the redemption and sold/put its warrant in foreign corporation generally within the same taxable year. Indeed, the termination of these interests is the purpose of all the steps. The individual steps of the transaction took place according to a prearranged plan and required careful timing and documentation. Various steps were carefully timed to trigger artificial attribution (e.g., the taxpayer's acquisition of options to acquire the

⁷ Cf. Rev. Rul. 68-601, 1968-2 C.B. 124 and Rev. Rul. 89-64, 1989-1 C.B. 91.

same number of foreign bank shares as the number of foreign bank shares purportedly redeemed). Detailed instructions were given to each participant to execute various steps of the transaction. Furthermore, the combination of steps in this transaction generally occurs within months. Foreign corporation and the taxpayer intended to dispose of their respective foreign bank shares and options after a relatively short, but coordinated, holding period, while the taxpayer intended to dispose of the foreign corporation warrant after the artificial attribution was arguably no longer required to assert the benefit of dividend treatment for the foreign corporation. The foreign corporation typically did not engage in any further business activity after the transaction.

Applying the Zenz rationale to the facts of this transaction, the redemption of the foreign bank shares and the taxpayer's sales of foreign bank options and stock and sale/put of the warrant back to the foreign corporation were undertaken pursuant to an integrated plan. The Zenz doctrine applies, in this case, to integrate the redemption and sales because the taxpayer intended to effectuate a separation of the taxpayer's interest in foreign bank (as well as in the foreign corporation) at the time of the redemption, and carried out this plan. Under Zenz, the individual steps of the integrated plan need to be characterized with consideration to the entire transaction, not in isolation. The redemption and sales combined either completely terminate foreign corporation's interest in foreign bank within the meaning of I.R.C. § 302(b)(3) or should be considered a substantially disproportionate distribution within the meaning of I.R.C. § 302(b)(2).⁸ See Zenz; Rev. Rul. 77-226; Rev. Rul. 75-447. The fact that the redemption occurs before the sales is irrelevant. As a result, foreign bank's redemption of foreign corporation's foreign bank stock is a sale or exchange under I.R.C. § 1001 and not a dividend distribution. Accordingly, there would be no basis to shift under Treas. Reg. § 1.302-2(c).

On January 15, 2003, the government won Merrill Lynch & Co., Inc. & Subsidiaries v. Commissioner, 120 T.C. No. 3. The Merrill Lynch case supports the above Zenz analysis. In Merrill Lynch, the Tax Court held that redemptions must be taxed as sales and exchanges under I.R.C. § 302(a) (rather than as dividends under I.R.C. § 301) where sales transactions occurring after the redemptions were integrated steps in firm and fixed plans to terminate the redeemed shareholders' actual or constructive ownership of the redeeming corporations. In determining that the later sales transactions were part of firm and fixed plans, the court stated that there need not be a binding commitment, nor even an agreement in principle, to undertake the later sales transactions. The court found the existence of firm and fixed plans where the evidence indicated the taxpayer intended to undertake the later sales as part of the plans. In

⁸The redemption may still qualify as a complete termination under I.R.C. § 302(b)(3) even where the taxpayer did not sell some of its foreign bank stock or options until years after the redemption. This may be the case, for example, if the taxpayer sold/put the warrant back to foreign corporation within the same taxable year as the redemption. The sale/put of the warrant back to foreign corporation terminated any attribution between foreign corporation and the taxpayer. As a result, the remaining foreign bank shares or options held by the taxpayer cannot be attributed to foreign corporation under the constructive ownership rules of I.R.C. § 318.

analyzing one of the transactions, the court stated that, “[w]hile there was some uncertainty regarding the details of the [later sale] . . . , there was no uncertainty that petitioner intended to [undertake the later sale]” as part of the plan. The court was convinced by the “totality of the facts and circumstances” that the taxpayer had a firm and fixed plan to undertake the later sale as part of “a carefully orchestrated sequence of steps designed to avoid . . . tax.” The plan was to engage in a multi-step transaction carefully structured to achieve very favorable tax basis adjustments that could eliminate gain. The facts convinced the court that the taxpayer “was prepared to do everything reasonably possible to facilitate the implementation of” that plan.

As in the Merrill Lynch case, it is irrelevant that the redemption in the basis shifting transaction may have occurred before the later transactions (such as the sales of the foreign bank shares and options, or the put of the warrant), that there may not have been a binding commitment (or agreement in principle) to undertake the later transactions at the time of the redemption, or that there may have been some uncertainty regarding the details of the undertaking of the later transactions at the time of the redemption. The Merrill Lynch court indicated that there need not be a binding commitment (or an agreement in principle) to undertake the subsequent steps before the plan will be considered firm and fixed, and that some uncertainty regarding the details of the subsequent steps will not prevent these steps and the redemption from being viewed as part of the firm and fixed plan. Instead, the redemption and the subsequent steps will be combined as long as it can be shown that they were integrated steps in the plan. As in the Merrill Lynch case, the totality of the facts and circumstances here indicate the taxpayers intended from the outset to carry out a carefully orchestrated series of steps that included the redemption and the later transactions. The plan required the implementation of these steps in order to create the alleged basis shift and tax losses that the taxpayer sought to offset against its unrelated capital gains.

The Taxpayers’ Position

The taxpayers argue that the Zenz step transaction doctrine, as it has been interpreted by the Service, steps together a taxpayer’s sale of a portion of its stock and the redemption of the rest of the same taxpayer’s stock to find a complete termination of the taxpayer’s interest. The taxpayers argue that in the situations involved herein, the taxpayer sold some or all of its foreign bank stock to third parties. The foreign bank did not redeem the taxpayer’s stock. Rather, the foreign bank redeemed the foreign corporation’s stock. The taxpayers conclude that neither Zenz nor the related step transaction doctrine is applicable in these transactions.

The taxpayers argue that Zenz should not apply to treat the taxpayer’s disposition of its foreign bank stock and foreign bank options as occurring in tandem with the foreign bank’s redemption of the foreign corporation’s foreign bank stock for purposes of determining whether the redemption resulted in a meaningful reduction in the foreign corporation’s ownership of foreign bank stock. The taxpayers argue that there was no agreement, either written or oral, binding or contingent, between the parties with respect to either the acquisition by the foreign corporation or the taxpayer of their respective

shares of foreign bank stock and foreign bank options, the redemption of foreign corporation's foreign bank stock or the taxpayer's disposition of some or all of its foreign bank stock and foreign bank options following that redemption. The taxpayers conclude that, absent such an agreement, Zenz should not apply.

Appeals Position, Settlement Consideration and Guideline

In Zenz v. Quinlivan, supra at pages 916-17, the Court observed that, "Whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to a distribution of a taxable dividend depends upon the facts and circumstances of each case." Further, "[s]ince the intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion is inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend."

Concerning the taxpayers' arguments, the Merrill Lynch court indicated a later transaction can be integrated with a redemption as long as the later transaction is an integrated step in a plan to terminate (or reduce) the redeeming shareholder's actual or constructive ownership in the redeeming corporation. The party that undertakes the later transaction (the taxpayer in these basis shifting cases) need not be the same party whose stock was redeemed (the foreign corporation in these basis shifting cases). Additionally, contrary to the taxpayers' other argument and as indicated above, the Merrill Lynch court indicated that there need not be a binding commitment to undertake the subsequent steps before the plan will be considered firm and fixed, and that some uncertainty regarding the details of the subsequent steps will not prevent these steps and the redemption from being viewed as part of the firm and fixed plan. Instead, the redemption and the subsequent steps will be combined as long as it can be shown that they were integrated steps in the plan.

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Sub-Issue 3

The Application of I.R.C. § 165

The Service's Position

The taxpayer's loss was not a bona fide loss allowable under I.R.C. § 165.

I.R.C. § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides that to be allowable as a deduction under I.R.C. § 165(a), a loss must be evidenced by a closed and completed transaction, fixed by identifiable

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Sub-Issue 4

The Application of I.R.C. § 269

The Service's Position

I.R.C. § 269 provides that, if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance may be disallowed.

For this purpose, “person” is broadly defined as an individual, trust, estate, partnership, association, company, or corporation. Treas. Reg. §1.269-1(d). Taxpayer is clearly a “person” for purposes of I.R.C. § 269.

One requirement is that the person acquires “control” of a corporation. I.R.C. § 269(a) defines “control” as the ownership of stock representing at least 50 percent of the total combined voting power of all classes of stock or at least 50 percent of the value of all classes of stock. The “acquisition of control”, however, may be direct or indirect. Acquisition of control occurs when one or more persons acquire beneficial ownership of stock representing the requisite control. Treas. Reg. § 1.269-5(a). That is, so long as the person has beneficial ownership of the equity of the corporation, record ownership is unnecessary. See Ach v. Commissioner, 358 F.2d 342, 346 (6th Cir. 1966) (holding that beneficial ownership constituted ownership within I.R.C. § 269 and record ownership was unnecessary); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976) (finding that traditional ownership attributes such as legal title, voting rights, and possession of stock certificates were not conclusive as to the ownership of stock). The determination of when a sale is complete and beneficial ownership has shifted is essentially a question of fact, taking into account all the facts and circumstances and viewing the transaction in its entirety. See Tennessee Natural Gas Lines v. Commissioner, 71 T.C. 74, 83 (1978), acq., 1979-2 C.B. 2. This is because the acquisition of stock means that the purchaser has assumed the risks of an investor in equity. See John Kelly Co. v. Commissioner, 326 U.S. 521, 530 (1946); Zilkha and Sons, Inc. v. Commissioner, 52 T.C. 607, 613 (1969), acq., 1971-1 C.B. xvi.

Whether the taxpayer acquired the requisite control of the foreign corporation through its acquisition of the foreign corporation warrant is essentially a facts and circumstances test that may be made, if appropriate, on a case-by-case basis. Depending on the facts, one may be able to raise an argument that the taxpayer acquired beneficial ownership of at least 50 percent of the value of all classes of foreign corporation's stock.

If the taxpayer acquired the requisite control of the foreign corporation, the acquisition of control must have occurred for the principal purpose of evasion or avoidance of Federal income tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Treas. Reg. § 1.269-3(a). This determination is also factual in nature. See Briarcliff Candy Corp. v. Commissioner, T.C. Memo. 1987-487.

The Taxpayers' Position

Citing Brick Milling Company v. Commissioner, 22 TCM 305 (1963), the taxpayers argue that they never acquired a 50% interest in the foreign corporation. A 50% interest is a requirement for the application of I.R.C. § 269. The taxpayers never acquired any stock of the foreign corporation. Rather, the taxpayers held a warrant entitling them to purchase shares of the foreign corporation and warrants are not treated as stock. The taxpayers argue that they did not acquire control of the foreign corporation within the meaning of I.R.C. § 269 and that section cannot be used to disallow the loss.

Additionally, the taxpayers make three other arguments:

Any argument that a taxpayer owned stock through ownership of the warrant would be misplaced. Ownership of warrants does not result in ownership of the underlying stock for tax purposes, absent a specific provision imputing constructive ownership to option holders. Commissioner v. Southwest Consolidated Corp., 315 U.S. 194 (1942); Rev. Rul. 77-437, 1977-2 C.B. 28 (for COD purposes, convertible bonds treated as debt, not stock, until converted); Rev. Rul. 64-25 1, 1964-2 C.B. 338 (options do not constitute stock for I.R.C. § 1504 purposes); GCM 39472 (Jan. 17, 1986) and cases cited therein.

Constructive ownership rules do not apply for I.R.C. § 269 purposes. Dorba Homes, Inc. v. Commissioner, 403 F.2d 502 (2d Cir. 1968), decision on remand sub nom.; Dewmar Construction Co., Inc. v. Commissioner, 28 T.C.M. 826 (1969). Nor does ownership of a warrant constitute "beneficial" or "indirect" ownership of the underlying stock. "Beneficial" ownership for I.R.C. § 269 purposes means equitable ownership arising out of a fiduciary relationship. Dorba Homes, supra; Dewmar Const., supra; cf. Rev. Rul. 70-63 8, 1970-2 C.B. 71 (ownership through trusts was considered beneficial ownership for I.R.C. § 269 purposes). "Indirect" ownership refers to ownership through lower tiers. See Brick Milling Co. v. Commissioner, 22 T.C.M. 1603, 1610 (1963), which explained, "[t]he indirect control provision of I.R.C. § 269(a) requires that there be ownership although it may be one or more steps removed, as in the case of a subsidiary of a directly owned parent corporation. See S. REP. No. 627, 78th Cong., 1st Sess., pp. 60-61 (1943), 1944 C.B. 973 at 1016; sec. 1.269-1(c), Income Tax Regs."

Rev. Rul. 82-150, 1982-2 C.B. 110, which involved a currently exercisable deep-in-the-money option, which was virtually certain to be exercised, cannot apply to treat the taxpayer as having acquired foreign corporation stock in substance. Rev. Rul. 82-150 was based on the premise that it was a virtual certainty that the taxpayer would exercise

his option. In contrast, although the facts varied in different forms in the FLIP transactions, exercise of the warrant was generally subject to certain restrictions (e.g., sixty days notice) and a “cash settlement” provision. Due to these terms, in contrast to Rev. Rul. 82-150, it was not a virtual certainty that the taxpayer would exercise the warrant. Furthermore, the ruling is of questionable validity and will be accorded no weight as authority, having been released twenty years ago yet never having been relied on or even cited by a court, and in fact cited only a handful of times by the Service. Significantly, the facts of Princeton Aviation Corp. v. Commissioner, 47 T.C.M. 575 (1983), involved a deep-in-the-money option to acquire stock, but neither the court nor the Service ascribed any significance to the option. See also GCM 39472, rejecting the field’s attempt to treat ownership of an option as equivalent to ownership of the underlying stock, based on economic substance arguments similar to those raised by the Service in these cases.

Appeals Settlement Consideration and Guideline

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Sub-Issue 5

The Application of the “At Risk” Provisions under I.R.C. § 465

The Service’s Position

The taxpayer was only at-risk as to amounts paid for foreign bank shares actually owned and options acquired. Accordingly, the taxpayer's losses are limited under I.R.C. § 465(b) to the amounts paid to purchase the foreign bank stock and options.

Even if the foreign corporation has basis in the foreign bank stock, and the foreign corporation’s basis shifts to the taxpayer, the taxpayer’s losses may be disallowed, in whole or in part, by I.R.C. § 465.

I.R.C. § 465(a)(1)(A) provides that in the case of an individual and a C corporation (with respect to which the stock ownership requirement of § 542(a)(2) is met) engaged in an activity to which I.R.C. § 465 applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the

taxpayer is at risk (within the meaning of I.R.C. § 465(b)) for such activity at the close of the taxable year.

I.R.C. § 465(b)(1) provides that a taxpayer is considered at risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity as determined under I.R.C. § 465(b)(2).

I.R.C. § 465(b)(2) provides that for purposes of I.R.C. § 465, a taxpayer is considered at risk with respect to amounts borrowed for use in an activity to the extent that taxpayer (A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property). No property is taken into account as security if such property is directly or indirectly financed by indebtedness that is secured by property described in I.R.C. § 465(b)(1).

I.R.C. § 465(b)(4) provides that, notwithstanding any other provision of I.R.C. § 465, a taxpayer is not considered to be at risk with respect to amounts protected against loss through non-recourse financing, guarantees, stop loss agreements, or other similar arrangements. The Senate report indicates that this provision is applicable to equity capital.

A taxpayer's capital is not "at risk" in the business, even as to the equity capital which he has contributed to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer. (S. Rept. No. 938, 94th Cong., 2d Sess. 49 (1976))

I.R.C. § 465(c)(3)(A) provides that I.R.C. § 465 applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. Thus, if the taxpayer is an individual, I.R.C. § 465 is applicable to the basis shifting transactions if they are undertaken for the production of income. Solely for purposes of this section the Service assumes that the taxpayer entered into the transaction for the production of income and that the limitations of I.R.C. § 465 apply to the transaction. The Service does not address whether it is appropriate for the taxpayer to treat this as an activity entered into for the production of income.

The reported cases applying I.R.C. § 465 typically involve nonrecourse liabilities. However, the statutory language of I.R.C. § 465 and the Senate Report language from the I.R.C. § 465 legislative history do not limit the application of I.R.C. § 465 to those types of cases. Senate Report No. 94-938, at page 47, provides that "a significant problem in tax shelters is the use of nonrecourse financing *or other devices* as a result of which the taxpayer is not personally liable for amounts which are attributed to his basis for purposes of the tax benefits from the investments" (emphasis added).

The legislative history provides that the purpose of the at risk rules is to "prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in

certain types of activities....” Senate Report No. 94-938, page 48. In enacting I.R.C. § 465, Congress was concerned about situations resulting in basis inflation beyond a taxpayer’s true economic exposure.

The Service argues that, assuming the foreign corporation actually acquired shares in the foreign bank, the foreign corporation obtained dividend treatment as a result of the redemption, and the basis shifted to the taxpayer, any loss reported by the taxpayer should be limited to the amount that the taxpayer was at risk in the transaction. Congress enacted I.R.C. § 465 to prevent those situations where a taxpayer may deduct a loss in excess of that taxpayer’s actual exposure to economic loss. The Service concludes that the I.R.C. § 465 at risk rules should be applied in this case to prevent the taxpayer from deducting a loss in excess of taxpayer’s true economic investment.

The Service also argues:

- Prop. Treas. Reg. § 1.465-22 does not provide authority for the taxpayer to argue that the income the foreign corporation has from the redemption of the foreign bank shares should be treated as the type of income that increases foreign corporation’s I.R.C. § 465 at risk amount.
 - Section 1.465-22(c)(1) of the proposed regulations states that a taxpayer’s amount at risk in an activity is increased by an amount equal to the excess of the taxpayer’s share of all items of income received or accrued from the activity during the taxable year over the taxpayer’s share of allowable deductions which are allocable to the activity for the taxable year. A taxpayer’s amount at risk in an activity is also increased by the taxpayer’s share of tax-exempt receipts from the activity.
 - Though I.R.C. § 302 recharacterizes certain amounts received in redemption of stock as dividends, as discussed earlier, the amount at issue in this case is not properly characterized as a dividend and is not income received by foreign corporation that would trigger the application of proposed regulation § 1.465-22(c)(1).
 - Further, while the term “tax exempt” receipts is not defined in the regulation or otherwise, the term tax-exempt income generally refers to income derived from an exempt organization or income specifically excluded from gross income. Tax-exempt income is a matter of legislative grace generally based on the advancement of certain social policies. The foreign corporation’s income is not subject to U.S. tax, is not a “receipt” of the taxpayer, and is not taxed to the taxpayer. There is no support for the argument that income not subject to U.S. tax is equivalent to tax-exempt receipts. The Service concludes in this case, the foreign corporation income not subject to U.S. tax is not treated as an item of income or a tax exempt receipt that increases the foreign corporation’s or the taxpayer’s at risk amount

- Finally, assuming for discussion purposes that the foreign corporation actually acquired shares in foreign bank, that the foreign corporation had a dividend as a result of the redemption, and that the basis shifted to the taxpayer, the Service does not agree with the taxpayers' interpretation that, relying on Prop. Treas. Reg. § 1.465-68, the at risk amount attributed to the foreign corporation's shares of stock redeemed is shifted to the taxpayer in a manner similar to the Treas. Reg. § 1.302-2(c) basis shift.
 - The statutory language of I.R.C. § 465 does not permit the shifting of at risk amounts to another taxpayer. Furthermore, Prop. Treas. Reg. § 1.465-68 does not provide support for the shifting of at risk amounts to another taxpayer in transfers like the basis shifting transactions addressed in Notice 2001-45. In Prop. Treas. Reg. § 1.465-68, Treasury and the Service have provided for the shifting of at risk amounts in specific types of transactions subject to the limitations provided in Prop. Treas. Reg. § 1.465-68(c).
 - For an at risk amount to be transferred from one taxpayer to another taxpayer, Prop. Treas. Reg. § 1.465-68(a) requires a transfer or disposition (except a disposition at death) in which a taxpayer transfers or disposes of that taxpayer's entire interest in the activity, that the basis of the transferee is determined in whole or in part by reference to the basis of the transferor, and that the transferor has an at risk amount which is in excess of losses from the activity. Under Prop. Treas. Reg. § 1.465-68(c), the transferee's increased at risk amount is limited to the amount of the transferee's basis that exceeds the amount the transferee is considered to have paid for the interest at the time of the transfer including the amount of liabilities to which the transferred property is subject.
 - In this case, the foreign corporation disposes of its entire purported interest in foreign bank stock in a redemption. The taxpayer relies on Prop. Treas. Reg. § 1.465-68 to argue that the foreign corporation's increased at risk amount, if any, from the dividend income as a result of the redemption should transfer to the taxpayer in a manner similar to the basis shift under Treas. Reg. § 1.302-2(c). The Service disagrees with the taxpayers' interpretation of Prop. Treas. Reg. § 1.465-68.
 - Assuming, for discussion purposes, that the taxpayer is treated as the owner of the foreign corporation stock under the I.R.C. § 318 attribution rules and Treas. Reg. § 1.302-2(c) for purposes of the basis shift, Prop. Treas. Reg. § 1.465-68 does not apply to basis shifting transactions. The taxpayer was not a transferee of an interest in an activity from the foreign corporation or an interest in the foreign corporation. Thus, the taxpayer is not a transferee as described in Prop. Treas. Reg. § 1.465-68(c).

- Finally, the Service argues that: (a) in Prop. Treas. Reg. § 1.465-68, the Treasury and the Service intended to provide relief in situations where the transferee acquires an interest in the activity and would suffer an economic detriment if the at risk amount were not transferred with the interest in the activity, and (b) the Proposed Treasury Regulation does not apply to these transactions. See Senate Report No. 94-938 at page 48. The Service concludes that I.R.C. § 465 would limit the taxpayer's deductions to the taxpayer's at risk amount, and the taxpayer's at risk amount would not be increased by the basis shifted amount.

If the taxpayer is a partnership subject to the unified audit and litigation procedures of I.R.C. §§ 6221-6234 ("TEFRA"), a two tiered determination of the at risk provisions is required. The character of the "dividend" as not transferring an amount at risk to the partners may be determined as part of the TEFRA partnership proceeding. See Treas. Reg. § 301.6231(a)(3)-1(a)(1)(vi)(C); Gemini Twin Fund III v. Commissioner, T.C. Memo. 1991-315 (recharacterization of note as non-recourse, affecting partners' at risk amount determined at partnership level); Allen Family Foods v. Commissioner, T.C. Memo. 2000-327 (effect of partnership transaction on partners' outside bases determined in a TEFRA partnership proceeding). However, an affected item notice of deficiency issued after the partnership proceeding is complete determines each partner's ultimate amount at risk and the limitation of each partner's deductions to this amount. See GAF Energy Partners, Ltd. v. Commissioner, 114 T.C. 519, 524-28 (2000) (affected item notice of deficiency cannot be issued prior to the completion of TEFRA proceeding); Hambrose Leasing v. Commissioner, 99 T.C. 298 (1992) (a partner's ultimate amount at risk is an affected item which cannot be determined in a partnership proceeding).

The Taxpayers' Position

In arguing whether taxpayers are at risk within the meaning of I.R.C. § 465 in the amount of their basis in foreign bank stock, foreign bank options, the foreign corporation warrant and the basis that shifted from the foreign corporation to the taxpayer as a result of the dividend from the foreign bank to the foreign corporation, the taxpayers argue:

The taxpayer was clearly at risk at least to the extent of his direct and indirect cash investment in the foreign corporation, and his cash investment in foreign bank stock, foreign bank stock options and the foreign corporation warrant. The taxpayer argues that the Service has not disputed this.

The foreign corporation was similarly at risk for the amount it invested in the foreign bank stock. The redemption of the foreign corporation's foreign bank shares was a dividend for U.S. tax purposes. Because the foreign corporation had no further interest in foreign bank, its basis in those shares shifted to the taxpayer. As a matter of policy and tax symmetry, as well as the application of Prop. Reg. § 1.465-68 (which provides under carryover basis circumstances that the at risk amount follows the transferred basis), the foreign corporation's at risk amount shifted to the taxpayer at the same time,

and in the same manner, that it's otherwise orphaned basis in foreign bank shares shifted to the taxpayer.

Accordingly, the taxpayer contends it was at risk for the full amount of the foreign corporation's basis in the foreign bank shares that shifted to it, and no adjustment under I.R.C. § 465 is warranted.

The only Service release to date that discusses the application of I.R.C. § 465 to these transactions is Chief Counsel Notice CC-2002-OO1. It states that the foreign corporation was not at risk with respect to the foreign bank shares but does not provide any useful analysis of the I.R.C. § 465 issues. Instead, it relies on general arguments to the effect that (i) the foreign corporation did not own the foreign bank stock, (ii) the redemption was not a dividend but a disposition of the foreign corporation's interest in the stock (and therefore the foreign corporation had no basis and presumably no at risk amount to shift), and (iii) the basis shift (and presumably also the shift of the at risk amount) was not "appropriate." Accordingly, the Service appears not to dispute that, in terms of I.R.C. § 465 analysis (leaving aside these other non I.R.C. § 465 issues), the foreign corporation's at risk amount was equal to its cost basis in the foreign bank stock, and/or the amount of the dividend it realized upon the redemption.

The taxpayer argues that the Chief Counsel Notice relies solely on the position that Prop. Reg. § 1.465-68 purportedly does not require a shift of the at risk amount under the taxpayer's precise fact pattern, because there was not a transfer of the foreign corporation's entire interest in the activity to the taxpayer. This elevates form over substance and goes beyond the express terms of Prop. Reg. § 1.465-68, which, in taxpayer's view, never requires a transfer of property from the foreign corporation to the taxpayer. The foreign corporation disposed of its entire interest in the activity, and its basis with respect to the activity was transferred to the taxpayer -- so the at risk amount should also shift to the taxpayer under Prop. Reg. § 1.465-68. The taxpayer is in the same position as any other transferee posited in the proposed regulation. He is in fact a transferee of the foreign corporation, in that he has a carryover basis from the foreign corporation and, in the absence of such a shift, both the foreign corporation's basis and the at risk amounts would disappear. This would be contrary to the policy of Treas. Reg. § 1.302-2(c) as well as the policy and terms of Prop. Reg. § 1.465-68.

Appeals Settlement Consideration and Guideline

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Sub-Issue 6

Whether the transaction as a whole lacks economic substance and

business purpose apart from the tax savings

The Service's Position

The stock loss may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

The Service argues that, to be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits that were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999) cert. denied 122 S.Ct. 1537 (2002); United States v. Wexler, 31 F.3d 117, 122, 124 (3rd Cir. 1994) cert. denied 513 U.S. 1190 (1995); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966), aff'g 44 T.C. 284 (1965) cert. denied 385 U.S. 1005 (1967); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd 270 F.2d 294 (3rd Cir. 1959) cert. denied 364 U.S. 908 (1960); Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3rd Cir. 1998) cert. denied 526 U.S. 1017 (1999).

Further, in determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F.2d 1229, 1237 (D.C. Cir. 1992); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction has economic substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

The Service also argues:

- Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.
- In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. The transactions lacked economic

substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 768.

In ACM Partnership, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. Id. at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits. But cf. I.E.S. Indus., Inc. v. United States, 253 F.3d 350, 355 (8th Cir. 2001) (stating that a "taxpayer's subjective intent to avoid taxes . . . will not by itself determine whether there was a business purpose to a transaction" and that steps to avoid risk may show "good business judgement consistent with a subjective intent to treat . . . trades as money-making transactions").

An objective analysis of the transactions involved herein reveals a lack of economic substance. The taxpayer's opportunity for gain and risk of loss on the transactions, a key indicator of economic substance, is minimal. The short-term nature of the transactions, transitory existence and lack of business purpose of the facilitating foreign corporation, and the absence of significant risk of loss to any party to the transactions all indicate the absence of any economic foundation to the transaction.

The tax benefits to be gained by participation in the transaction far outweigh the business/investing purposes purportedly behind the participation of the various taxpayers in the basis shift. The taxpayer's acquisition of the foreign corporation warrant had no useful business purpose as it was highly unlikely that the taxpayer would exercise the warrant to acquire a controlling interest in the foreign corporation. In addition, the foreign corporation's acquisition of foreign bank stock with a collar¹⁰ around a price that was lower than the purchase price served no economic purpose other than to lock in a small economic loss. Aside from the remote possibility of gain (or reduction in transaction costs) because of the integrated forward feature of the call options, there

¹⁰ An equity collar is the simultaneous purchase of a put option and the sale of a call option. In these transactions, the equity collar is two contracts, a put that limits the foreign corporation's downside risk coupled with a call that limits the foreign corporation's upside gain. The pricing of the call and put options in these transactions essentially lock in a 5% loss to the foreign corporation with the gain potential limited to the integrated forward feature of the call option.

does not seem to have been any significant economic consequences of the transaction other than the creation of a tax loss for the taxpayer.

The taxpayers in these cases have large capital gains which are totally unrelated to the basis-shifting transactions. Through participation in the transaction, taxpayers purport to sell options to acquire bearer shares of foreign bank stock and/or foreign bank bearer shares for total tax losses approximately equal to the unrelated capital gain. The close relationship between the original tax gain and the total purported losses suggests that taxpayers did not enter into the transaction for a non tax business purpose. As the Tenth Circuit has recognized, "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Keeler v. Commissioner, 243 F.3d 1212, 1218 (10th Cir. 2001), citing Freytag v. Commissioner, 89 T.C. 849, 877-878 (1987).

In addition, the formation of the foreign corporation is suspect and may be disregarded under the economic substance test. There was no business purpose for the creation of the offshore corporation. Its only activities were those related to the transaction and collection of the hefty fees provided by the written investment advisory agreement between the foreign corporation and the promoter for its involvement in the transaction.

The Service concludes that the transaction should be viewed as a sham in substance and any tax benefits, fees or expenses related thereto should be disallowed.

The Taxpayers' Position

The taxpayers identify the Service's arguments as follows:

The transaction as a whole is a sham in substance.

The transactions involving the foreign corporation are shams in both fact and substance.

With respect to the "sham in fact" argument, the taxpayers argue that their investigation thus far reveals no basis for the Service's allegation that the transactions between the foreign corporation and the foreign bank did not occur. The taxpayers believe the Service simply is confused by the substantiation of a seller financed purchase of bearer shares and that, far from being a case of fictitious transactions, this will reduce to an argument over the characterization of real transactions (i.e., was there a "true sale" for tax purposes).

With respect to the "sham in substance" argument, the taxpayers argue that the Service commits legal error by asserting that this doctrine applies to the entire design of the transaction. Neither the Supreme Court nor any appellate court has ever adopted such a rule. The sham in substance test derives from the Supreme Court's decision in Frank Lyon Co. v. United States, 435 U.S. 561 (1978): "To treat a transaction as a sham, the court must find [i] that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and [ii] that the transaction has no economic substance because no reasonable possibility of a profit exists." Although the

circuit courts have not adopted a uniform formulation of the "sham in substance" doctrine, all of the circuits inquire into these two factors. In some circuits, both of these factors must be shown to exist before there will be a sham finding (e.g., D.C. and Federal Circuits, Fourth and Seventh Circuits). In other circuits, a finding of only one factor is sufficient (e.g., First and Eleventh), but many circuits have not settled on a test (e.g., Fifth and Eighth). Importantly, in the very cases usually cited as creating the sham transaction doctrine, the Supreme Court has repeatedly held that the taxpayer's subjective motive to reduce taxes, without more, will not invalidate a transaction. See e.g., Gregory v. Helvering, 293 U.S. 465, 469 (the Court "put aside" any finding by the District Court regarding subjective tax motives); Knetsch v. United States, 364 U.S. 361, 365 (same); accord, Frank Lyon, 435 U.S. at 580.

The sham in substance test requires a case-by-case determination. As applied by the circuit courts, the first prong, the taxpayer's business purpose motive, is a subjective inquiry. We believe that, in the great majority of these transactions, the evidence will show that not only were the taxpayers motivated by business purposes apart from tax benefits in entering the transaction, but that the taxpayers entering into these transactions intended to make positive cash profits on their investments in the foreign bank shares, foreign bank options, and foreign corporation warrants. A number of taxpayers in fact succeeded in making a large return on their investment. For example, some taxpayers saw their shares of foreign bank appreciate significantly, generating excellent returns on both the shares and the options. As with many stock and option investments, volatility can be significant over periods of less than one year, and it is the fortuity of good timing that largely determines the difference between profitable and unprofitable trades.

The second prong of the sham in substance test, the reasonableness of the profit potential, is an objective inquiry. The taxpayers believe the evidence will show that the taxpayers had an objectively reasonable basis for their belief they could make a profit. This belief must be tested based on facts known or reasonably knowable to the taxpayer before entering into the transaction. Apropos of risky investments, courts have held that a "small chance of making a large profit" may suffice. See e.g., Jacobson v. Commissioner, 915 F.2d 832, 838 (2d Cir. 1990) (citing the example of wildcat oil drilling in Treas. Reg. § 1.183-2(a)).

The taxpayers argue that the Supreme Court has never held that a transaction lacks economic substance or may be disregarded because it lacks a pre-tax profit motive. The Court in Frank Lyon refused to ignore the "reality" that "tax laws affect the shape of nearly every business transaction." 435 U.S. at 580. Some circuit courts have held that the transaction must have an opportunity for profit apart from tax benefits. But none of these circuits has adopted a rule ignoring an admitted pre-tax profit if the size of the tax benefits obtained is "too large" in relation to the pre-tax profit. If anything, the few appellate courts to have addressed the issue take a practical view, acknowledging the importance of tax benefits to all commercial and investment transactions. See e.g., I.E.S. Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); Northern Ind. Pub. Serv. Co. v. Commissioner, 115 F.3d 506 (7th Cir. 1997) ("NIPSCO"); Fabreeka Products Co. v.

Commissioner, 294 F.2d 876 (1st Cir. 1961); Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995).

Finally, the taxpayers argue that the sham in substance test applies to them and not the other parties to the transaction. Therefore, it is the taxpayers' motive that counts, not that of the foreign bank, the foreign corporation or any other party. Similarly, it is the evidence relating to the taxpayers' objectively reasonable belief that controls, not that of any other party. The taxpayers argue that the Service appears to be suggesting that every step of the transaction (and every party) has to satisfy both prongs of the broadest formulation of the sham test, and that it is the taxpayers' burden to prove all of these elements. The taxpayers argue that there is categorically no basis in law for this approach. The case law, beginning from Gregory, and continuing through United Parcel Serv. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) and Compaq, merely requires that real business transactions occurred, resulting in real changes in economic position by the parties, all of which occurred here.

Appeals Settlement Consideration and Guideline

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Settlement Considerations and Guidelines

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For Appeals settlement purposes, the following is recommended:

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Issue 2

Whether the Service should assert the appropriate I.R.C. § 6662 accuracy-related penalties against taxpayers who entered into the “basis shifting” transactions.

Overview of the Issue

In Notice 2001-45, 2001-33 I.R.B. 129, the Service stated that it may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under I.R.C. § 6662, the return preparer penalty under I.R.C. § 6694, the promoter penalty under I.R.C. § 6700, and the aiding and abetting penalty under I.R.C. § 6701.

On January 14, 2002, in Announcement 2002-2, 2002-2 I.R.B. 304, the Service announced a disclosure initiative to encourage taxpayers to disclose their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate if there is an underpayment of tax. If a taxpayer discloses any item in accordance with the provisions of this announcement before April 23, 2002, the Service would waive the accuracy-related penalty under I.R.C. § 6662(b)(1), (2), (3), and (4) for any underpayment of tax attributable to that item.

The Service would waive the accuracy-related penalty if the taxpayer discloses the item before the earlier of (1) the date the item or another item arising from the same transaction is an issue raised during an examination, or (2) April 23, 2002.

Discussion and Analysis

I.R.C. § 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and

(3) any substantial valuation misstatement under chapter 1. Treas. Reg. § 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See D.H.L. Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by, 285 F.3d 1210 (9th Cir. 2002) (the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under I.R.C. § 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable).

The Service's Position

In its argument for the application of the accuracy-related penalty, the Service discusses the factors giving rise to the accuracy-related penalty.

Negligence is one such factor. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c) and Treas. Reg. § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g 43 T.C. 168 (1964). Treas. Reg. § 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. In Compaq v. Commissioner, 113 T.C. 214 (1999), rev'd on other grounds, 277 F.3d 778 (5th Cir. 2001), the Service argued that Compaq was liable for the accuracy-related penalty because Compaq disregarded the economic substance of the transaction. The court agreed with the Service's position and asserted the accuracy-related penalty for negligence because Compaq failed to "investigate the details of the transaction, the entity it was investing in, the parties it was doing business with, or the cash-flow implications of the transaction." Compaq v. Commissioner, 113 T.C. at 227. Where a taxpayer reported losses from a transaction that lacked economic substance and reported capital losses that would have seemed, to a reasonable and prudent person, to be "too good to be true," then the accuracy-related penalty attributable to negligence may be appropriate. If the taxpayer reasonably relied upon a tax opinion provided by a professional tax advisor, then it will be difficult to assert the negligence penalty because reliance on the advice will likely establish that the taxpayer made a reasonable attempt to ascertain the correctness of its position. On the other hand, if correspondence indicates the taxpayer knew the transaction was "too good to be true," the negligence penalty may be appropriate.

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 for a corporation, other than an S corporation or a personal holding company). I.R.C. § 6662(d)(1). In the case of any item of a taxpayer

other than a corporation which is attributable to a tax shelter, understatement penalties are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, if (2) the taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. I.R.C. § 6662(d)(2)(C)(i). For purposes of I.R.C. § 6662(d)(2)(C), a tax shelter is a partnership or other entity, an investment plan or arrangement, or other plan or arrangement where a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax. I.R.C. § 6662(d)(2)(C)(iii). A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if (1) the taxpayer analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than fifty-percent likelihood that the tax treatment of the item will be upheld if the Service challenges it, or (2) the taxpayer reasonably relies, in good faith, on the opinion of a professional tax advisor, which clearly states (based on the advisor's analysis of the pertinent facts and authorities) that the advisor concludes there is a greater than fifty percent likelihood the tax treatment of the item will be upheld if the Service challenges it. Treas. Reg. § 1.6662-4(g)(4). Usually, the understatement attributable to the disallowance of the capital losses claimed exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000 (\$10,000 for a corporation, other than an S corporation or a personal holding company). Therefore, a substantial understatement penalty may be applicable. The understatement penalty may apply, for example, where the taxpayer claims to have relied upon a tax opinion from an accounting firm or a law firm but didn't receive such an opinion until after it had already filed its federal tax return. In this situation, the taxpayer could not have reasonably relied on the tax opinion in reporting the transaction for federal tax purposes.

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed \$5,000 (\$10,000 for a corporation, other than an S corporation or a personal holding company). A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis. I.R.C. § 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." I.R.C. § 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent penalty under I.R.C. § 6662(a) is increased to 40 percent. I.R.C. § 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992) (applying I.R.C. § 6659, repealed and replaced by I.R.C. § 6662). If the adjusted basis of the foreign bank stock and options is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the adjusted basis of the foreign bank stock and options is 400 percent or more of the correct amount, then a gross valuation misstatement exists. In many cases, the basis overstatement will be of such a magnitude that a gross valuation accuracy-related penalty will be appropriate. Again,

this penalty will only be appropriate if the taxpayer did not reasonably rely on a tax opinion.

I.R.C. § 6664 provides an exception to the imposition of accuracy-related penalties if the taxpayer shows that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. See I.R.C. § 6664(c); United States v. Boyle, 469 U.S. 241 (1985). Whether a taxpayer acted with reasonable cause and in good faith is a factual question. Treas. Reg. §§ 1.6664-4(b)(1)(C)(1)(i) and 1.6662-4(e)(1). Generally, the most important factor is the extent to which the taxpayer exercised ordinary business care and prudence in attempting to assess his or her proper tax liability. See Estate of Simplot v. Commissioner, 112 T.C. 130, 183 (1999) (citing Mandelbaum v. Commissioner, T.C. Memo. 1995-255), rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001). Note that failure to disclose a listed transaction, such as a transaction falling within the scope of Notice 2001-45, evidences a lack of good faith by the taxpayer and may be sufficient to preclude any defense under I.R.C. § 6664.

(i) Whether penalties apply to the underpayment attributable to the disallowance of capital losses claimed from the transaction must be determined on a case-by-case basis depending on the specific facts and circumstances of each case.

Special rules apply in transactions involving a partnership subject to the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234 (which may occur, for example, where the taxpayer forms a partnership that participates directly in the transaction). For taxable years ending after August 5, 1997, penalties may be determined at the partnership level. I.R.C. § 6221. Treas. Reg. § 301.6221-1, effective for years ending after October 3, 2001, provides as follows:

(c) Penalties determined at partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner-level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership-level determinations. Partnership-level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner-level defenses specified in paragraph (d) of this section.

(d) Partner-level defenses. Partner-level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceeding, but may be asserted through separate refund actions following assessment and payment. See I.R.C. § 6230(c)(4). Partner-level defenses are limited to those that are personal to the partner or dependent upon the partner's separate return and cannot be determined at the partnership level. Examples of these determinations are

whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of I.R.C. § 6664(b) (penalties applicable only where return is filed), or I.R.C. § 6664(c)(1) (reasonable cause exception) subject to partnership-level determinations as to the applicability of I.R.C. § 6664(c)(2).

Following prior partnership law with respect to partnership items, relevant inquiries into tax motivation and negligence with respect to partnership level determinations of penalties should be determined with reference to the state of mind of the general partner. See Wolf v. Commissioner, 4 F.3d 709, 713 (9th Cir. 1993); Fox v. Commissioner, 80 T.C. 972, 1008 (1983), aff'd 742 F.2d 1441 (2nd Cir. 1984); aff'd sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984); Zemel v. Commissioner, 734 F.2d 5-9 (3rd Cir. 1984). Nevertheless, to the extent the general partner essentially acted as the alter ego of the taxpayer, the taxpayer's intent is relevant in this context.

Partner-level defenses may only be raised through subsequent partner-level refund suits. See Treas. Reg. §§ 301.6221-1(d) and 301.6231(a)(6)-3. Good faith and reasonable cause of individual investors pursuant to I.R.C. § 6664 would be the type of partner level defense that can be raised in a subsequent partner-level refund suit. However, to the extent that the taxpayer effectively acted as the general partner and that the intent of the general partner is determined at the partnership level, it is likely that such partnership level determinations may also dispose of partner-level defenses under the unique facts of each case.

(ii) Whether the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234 apply to the tax shelter adjustments.

If the shelter adjustments at issue are generated by a TEFRA partnership, then the income and deductions of the partnership can only be adjusted under the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234. In addition to income, deductions and credits of the partnership, the TEFRA procedures would also apply to any reallocation of partnership items including any reallocation under I.R.C. § 482. See Treas. Reg. § 301.6231(a)(3)-1(a); Blonien v. Commissioner, 118 T.C. 541 (2002).

Even if the deductions at issue do not flow directly from the partnership, if the taxpayer at issue is a partner in a TEFRA partnership, and received a distribution from a TEFRA partnership, the partner's carryover basis in the distributed asset is a partnership item, which must be determined under the TEFRA procedures. See Treas. Reg. § 301.6231(a)(3)-1(c)(3)(iii). Similarly, the partnership's carryover basis in any asset contributed by a partner is a partnership item. Treas. Reg. § 301.6231(a)(3)-1(c)(2)(iv).

Based on the above, if a TEFRA partnership is used to implement a "basis shifting" tax shelter, the various components of the transaction should be reviewed to determine if any portion of the adjustments will require the initiation of a TEFRA partnership proceeding.

If the TEFRA partnership procedures apply, certain adjustments may constitute “affected items” which cannot be adjusted prior to the completion of the TEFRA partnership proceeding. See GAF Corp v. Commissioner, 114 T.C. 519, 528 (2000). Affected items which must be asserted through an affected item notice of deficiency after the conclusion of the TEFRA proceeding include limitations of losses to a partner’s basis in his partnership interest under I.R.C. § 704(d), or amount at risk under I.R.C. § 465. For corporate taxpayers, the corporation’s motive under I.R.C. § 269 in acquiring the partnership interest is also an affected item.

If a TEFRA partnership is involved, the settlement of the at risk issue must be bifurcated. The transfer of amounts that affect the partner’s at risk amount is addressed on Part I of the Form 870-L(AD) or Form 870-LT(AD), and the partner’s ultimate amount at risk is determined in Part II of the Form.

The Taxpayers’ Position

The taxpayers contend that they conducted extensive due diligence regarding the transactions. Then, before filing their tax returns, the taxpayers assert they generally obtained a tax opinion from one or more well respected tax advisors (an accounting firm, a large law firm, or both). These opinions were based on each taxpayer’s individual facts, not on generic facts. The tax advisors conducted independent reviews of the transactions, including reviews of documents and information from the Investment Advisors. On the basis of the facts, each opinion concluded that it was more likely than not that the taxpayer’s treatment of the losses from the transactions would be upheld if challenged by the Service.

Even if it is assumed arguendo that the claimed losses are ultimately disallowed, the United States Supreme Court has made it clear that:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a “second opinion,” or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. United States v. Boyle, 469 U.S. 241, 251 (1985).

Most of the taxpayers in fact obtained a second opinion and thus went beyond what is required by the highest court of this land.

In conducting due diligence or relying on the tax opinions, the taxpayers say they made efforts to assess their proper tax liabilities and reasonably relied in good faith on tax advice from professional tax advisors whose opinions met the requirements of Treas. Reg. § 1.6664-4(c). Consequently, under Boyle, the taxpayers contend they acted with reasonable cause and in good faith and, pursuant to I.R.C. § 6664(c)(1), are not liable for any of the accuracy-related penalties under I.R.C. § 6662. See also Chamberlain v. Commissioner, 66 F.3d 729 (5th Cir. 1995); Mauerman v. Commissioner, 22 F.3d 1001

(10th Cir. 1994); Kantor v. Commissioner, 998 F.2d 1514 (9th Cir. 1993); Vanderheide v. Commissioner, 75 TCM 1588 (CCH) 1998; Daoust v. Commissioner, 67 TCM 2914 (CCH) 1994; Hill v. Commissioner, 66 TCM 909 (CCH) 1993. Recent correspondence from the Service includes the contention that the taxpayers may not rely on the tax opinions to defend the accuracy-related penalties. However, absent some evidence that would reasonably alert a prospective investor that opinions from an accounting firm or a reputable law firm should be suspect, the taxpayers say that reliance on the tax opinions was reasonable under the circumstances. Balboa Energy v. Commissioner, 2001-1 U.S.T.C. ¶50,426 (reversing the Tax Court and holding that reliance on a tax opinion contained in placement memorandum was reasonable). Before the Service listed the I.R.C. § 302/318 basis shifting transaction on July 26, 2001, there was no evidence that would alert a prospective investor that reasoned opinions regarding such transactions should be suspect. Accordingly, the taxpayers contend that reliance on the tax opinions was reasonable and in good faith, and under Boyle, they were not required to second-guess their tax advisors.

Similarly, the taxpayers assert they are not liable for the substantial understatement penalty because there was, at a minimum, substantial authority for the treatment of the items and because they reasonably believed that the tax treatment of the items was more likely than not the proper treatment. I.R.C. §§ 6662(d)(2)(B)(i) and (d)(2)(C)(i)(II). In forming their reasonable belief that the tax treatment of the items was more likely than not the proper treatment, taxpayers say they reasonably relied in good faith on tax advice from professional tax advisors whose opinions met the requirements of Treas. Reg. § 1.6664-4(c). See also Mauerman v. Commissioner, 22 F.3d 1001 (10th Cir. 1994); Krause v. Commissioner, 99 T.C. 132 (1992); Mollen v. Commissioner, 93-2 U.S.T.C. ¶50,585; Erhard v. Commissioner, 64 TCM 10 (CCH) 1992.

Appeals Position

The determination of whether an accuracy-related penalty is applicable to any portion of the underpayment attributable to the I.R.C. §§ 302/318 basis shifting transaction is predicated upon the facts and circumstances of the taxpayer's case. Discussed above are the law, court decisions, and factors used in determining the applicability of the assertion of the accuracy-related penalty. If an accuracy-related penalty is asserted by the Service, Appeals Officers should use such law, court decisions, and factors in assessing the hazards of litigation.